January 24, 2000

__Government Management, Not Private Markets, Threatens Economy__

Stock Market Growth Reflects Economic Potential

In a provocative piece about the Nasdaq's rapid wealth accumulation, columnist Robert Samuelson borrowed early 20th century economist John Maynard Keynes' analogy likening a stock market to a casino [*Washington Post,* 1/12/00]. Yet Samuelson left unanswered many questions his article raised. Because these questions could easily be answered incorrectly and thus lead to hampering the proper functioning of both the high-tech-dominated Nasdaq Stock Market and private capital markets, this paper addresses Samuelson's piece.

The gist of Samuelson's op-ed is that the Nasdaq's rapid increase in valuation represents speculation run amuck to the detriment of legitimate investment. Certainly the Nasdaq has experienced tremendous capital appreciation over the last few years. Yet this fact by itself hardly proves the point that its increase either has been divorced from real economic factors or that such a rise is detrimental. In fact, it is Samuelson's implicit question as to what should instead be the proper method for distributing capital in the American economy that should cause concern.

All Stocks, Not Just Nasdaq, Have Been Gaining

It is not the Nasdaq alone that is rapidly increasing. Historically, all stocks are doing extraordinarily well. From 1966 to 1997, stocks gave a real rate of return of 6 percent. However, from 1982 to 1997, their real rate of return has been 12.8 percent. Thus, it is quite possible to discern different patterns within the same time frame. Focusing on the Nasdaq's performance during just the last four years does just that. From the Nasdaq's inception in 1971 through 1994, it experienced a nominal average annual growth rate of 8.5 percent — in comparison, all stocks produced a growth rate of 8.4 percent from 1802 through 1997.

As Samuelson notes, the Nasdaq represents not a cross section of American business but a specific segment: the area with the most rapid and arguably the greatest potential growth. It is also the one in which the United States is far and away the world's leader. It is not just America's leading industry, but the world's, that is centered in the Nasdaq. Not surprisingly, such leadership should be reaping rather dramatic returns.

Economic Factors Underlying Nasdaq Increase

The relatively strong performance of the Nasdaq has not been the overnight phenomenon Samuelson suggests. Investment in information technology (referred to as "IT") has been occurring roughly as long as the Nasdaq itself has been around — nearly three decades. Yet for years, it was an axiom of economic analysis that large "IT" investments were not yielding commensurate returns. Apparently they now are. And so largely as a result of "IT," productivity — which had existed in the "one percents" in every year of this decade (except the post-recession rebound year of 1992) — was 2.9 percent in 1996, 2.2 percent in 1997, 2.8 percent in 1998 and 2.8 percent from the third quarter of 1998 through this year. It is logical that big returns would follow such dramatic results and potential.

Samuelson does not examine the equally important question of comparative returns in other investments. Of course, the most common counterpoint to stock investment is bond investment. It is not coincidental that general stock appreciation has followed a dramatic decline on bond yields. In December 1980, "stagflation" had driven interest rates on the 30-year Treasury bond to 21.5 percent. Today that bond yields approximately 6.5 percent.

Finally, Samuelson also neglects to mention the source of the wealth driving Nasdaq prices. Baby boomers, America's largest and wealthiest age cohort, are now in their top earning years — and widely are using this time to fund retirement and children's future education. This massive amount of cash has to go somewhere.

In short, the Nasdaq represents the world's leading industry. It is giving strong evidence of its economic potential. This potential is greater than either that of the steam or internal combustion engines. To paraphrase Samuelson, we are, in fact, "writing history." This industry is centered in this country, which gives Americans an inside track on investing in it. The United States, with an economy more than twice that of the world's second largest, has simultaneously seen its largest age group reach its greatest earning capacity and has experienced a rapid decrease in the return on alternative investments. Nothing in this scenario smacks of speculation. It is not, as Samuelson writes, that "old investment rules have been rewritten or repealed," but rather that they are logically responding to a coincidence of positive economic factors.

Keynesian Policy the Real Threat to the Economy

This does not mean that speculation doesn't exist in the Nasdaq or any stock market. Certainly it does. Yet this does not detract from their real economic role of capital allocation. And it is to this essential role that Samuelson's implicit message presents a danger.

Having presented what he discerns to be a problem, Samuelson tacitly asks: what is to be done? By concluding with a quote from Keynes, he reminds us of an ominous answer. For two generations Keynesian thinking, that governments could better manage a society's wealth than the society's private workings, held sway. It was only by freeing ourselves from this mindset and its consequences — witness the earlier cited "stagflation" resulting from attempts to control the economy through the money supply — that the unprecedented economic growth we have experienced for the last 20 years has been possible. The worst lesson we could take from the recent performance of the Nasdaq is that there should again be a government attempt to control the allocation of capital.

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